



THE AUDITING OF THE LOCAL GOVERNMENT'S FINANCIAL MANAGEMENT IN AZERBAIJAN; COMPARATIVE ANALYSIS

Prepared by

Center for Economic and Social Development (CESD)
Baku, Azerbaijan

Center for Economic and Social Development (CESD)
Shirin Mirzeyev 76 "a" / 33,
Baku Az1002,
Azerbaijan
Phone: (99412) 4 971161
Fax (99412) 5984431
Email; cesd@aztelekom.net
Web; <http://www.cesd.az>

REPORT ON THE AUDIT OF THE LOCAL GOVERNMENT'S FINANCIAL MANAGEMENT IN AZERBAIJAN

Foreword

The audit delivered in the country mainly aims to obtain reasonable assurance about whether the financial statements of economic entities are free of material misstatement. Historically, practices of audit function were directly associated with the interests of firms and their owners. Yet there has been a pressing need to audit the financial affairs of governments in respective countries over the past decades. It is in the first place attended by improvement of fiscal transparency and accountability by promoting good practices of audit function and enhancement of efficiency in government's management.

Local governments' financial management is markedly different from the similar system in the business sector, since accounting of the private sector must provide for profit and market adaptation. But local government function is limited to State Budget subventions and it chiefly targets to render public services rather than making profit. Therefore, accounting standards used by local governments must cover and/or reveal budgeting and realities of budget execution as a major mechanism for management of financial resources.

Undoubtedly, it is just possible to assess how far the accounting system is effective thanks to its adequate scrutiny. The results of the audit local governments' financial management and auditors reports provide the solution to a number of issues. **First**, such reports highlight full and factual information on how far the efficiency of receipts and expenditures forecast is enhanced and the financial operations are performed.

Secondly, it enables to assess factual financial needs to implement a multiple of social and economic programs of local governments. **Thirdly**, it provides for fiscal transparency in local government function. **Finally**, it helps to measure the efficiency and effectiveness of programs implemented by local governments.

Proceeding from the above above-mentioned, we can classify to three groups potential users of information on the system of local government audit. The **external users** group of financial information includes local communities, donors and funders, sellers of goods (work, services) for local governments. The **internal users** group of financial information includes specialists employed by local bodies (financial managers, experts in charge of supervising budget planning, et all in particular). The **last information users** are the group that is a key factor in greatly enhancing the performance of local governments, yet this group has not been directly involved in their daily function. It consists of state-run structures rendering subventions to local governments in diverse forms, as well as legislative structures. The former particularly may require a special accountability system to make sure how far the use of the subventions is effective.

I. THE SYSTEM OF LOCAL GOVERNMENT AUDIT IN AZERBAIJAN AND TYPES OF AUDIT SERVICES

The system of both central and local governments audit in Azerbaijan like most of the transition countries has been shaped since the nineteenth of last century.

Proceeding from the practice of diverse countries, local government audit is deemed to be a more complicated process facing peculiar difficulties. It is chiefly due to presence of numerous local government bodies having different nature and distinctive functions in a same administrative and territorial unit.

For example, under the Republic of Azerbaijan's Constitution, Authority of the Local Executive power determined by the President of the Azerbaijan Republic and municipalities formed by way of elections shall perform duties of local government. Suffice it to say that the number of institutions undertaking functions in accordance with the concept "local government" approaches 2850 (including 85 Executive powers in regions (towns) and 2757 municipalities). In this situation, practices of audit function in local government are undoubtedly becoming somewhat difficult. Nevertheless, the number of central government bodies acting as executives of budgetary funds (ministries, committees, government agencies, etc) even does not reach 100. In Azerbaijan, local government audit is regulated by appropriate legislative acts. The following are major existing normative-legal documents on local government audit:¹

- 1) *The Republic of Azerbaijan's Law dated 7 December 2001 on the Chamber of Auditors*
- 2) *Law of Azerbaijan Republic dated of 5 March 2002 on approval of the Internal Charter of the Chamber of Auditors of the Azerbaijan Republic*
- 3) *Law No. 882 on Auditor Services of the Azerbaijan Republic dated of 16 September, 2003*
- 4) *Resolution 009 dated of 13 January 1998 of the Cabinet of Ministers of the Azerbaijan Republic on approval of procedures for issuance of special permits (licenses) for involvement in audit activities in the Azerbaijan Republic*
- 5) *Audit Standards No 42/1 dated 7 Dec 1999 approved by the Board of the Chamber of Auditors of the Azerbaijan Republic*
- 6) *Resolution 38-I QR of the Milli Mejlis of the Azerbaijan Republic dated of 12 March 1996 on State Registration of Independent Auditors and Audit Companies*
- 7) *Resolution 1115 dated of 19 September 1995 of Milli Mejlis of the Azerbaijan Republic on approval of the Charter of the Chamber of Auditors of the Azerbaijan Republic*
- 8) *Resolution 159/5 dated of 23 December 2005 on recommended minimum limits of the cost of audit services approved by the Board of the Chamber of Auditors of the Azerbaijan Republic*
- 9) *Azerbaijan's Law on administrative control of the activities of auditors dated of 13 May 2003*
- 10) *Law No.358-II QD of the Azerbaijan Republic (Articles 11, 22, 39) dated of 02 July 2002 on "Budget System"*
- 11) *Law of the Republic of Azerbaijan on "Accounting" dated June 29, 2004, etc.*

¹ All legislative acts have been quoted from www.vescc.com and www.e-qanun.az

In addition, there are a multiple of secondary normative/standard acts (rules and regulations of individual Government and State Audit bodies) regulating scrutiny of local governments' financial management. The most important requirements of these documents will be detailed throughout report preparation in case of need.

In international practice there are forms of audit services – internal and external audit. **Internal audit** functions as independent structures within local government and much of its work performed is based on local government's system of internal control. The internal auditors report to local governments.

The primary functions of internal auditing extends to oversight funds' use, avoidance of unnecessary costs, confirmation of accuracy of information local government's management use for decision-making, oversight of accuracy of economic operations, analysis of fiscal performance efficiency and proposals for its enhancement, data quality assessment for management system.

External audit program encompasses engaging an independent auditor to assess local government's activity and accountability. In respect to such approach, it is worth speaking only about external audit of local governments in Azerbaijan. Since the legislation in effect fails to take into account establishment of internal audit bodies or structures performing financial control. Since Resolution No 138 dated of 16 June 1999 on Local Executive Authority establishes standard structures of the said local authority. According to legislation, Local Executive Authority shall be comprised of 21 divisions, departments and services (legal, software, information, etc). However, the legal framework does not provide for any financial entity. Moreover, item 3.3.3 of the International Monetary Fund (IMF) guidelines to ensure transparency in the budget and tax system shows that internal audit of government's affairs is one of the key means to prevent misuse of funds or inadequate management. The bank experts however claim that not only should be made available the internal audit procedures to the public, but also external auditors should be able to assess their efficiency and viability.²

The state of internal audit in municipal companies is also the same. In fact, no institutional and policy framework guiding the activity of local self government in Azerbaijan encompasses establishment of the internal audit system in municipalities. For example, the functions vested to municipal councils, which perform major functions of local self-government structures, executive power of municipalities and standing commissions exclude well-established norms for internal audit of municipalities. Only Article 13.1 of the Law on financial bases for municipalities roughly stipulates that municipal bodies control over local budget execution. And it is a much more speculative legal norm - it is not obvious which municipal structures should scrutinize it, and what are forms of scrutiny. Another example: under Article 12.1 of the Law on local (municipal) taxes, the financial activity of municipalities shall be scrutinized by Review Commissions comprised of community members who are subject to approval in municipality meetings. As is seen, that is not professional audit in municipal bodies, but purely community audit. Finally, such legal uncertainty associated with internal audit is reflected in the presidential decree dated of 4 June 2001 on Rules for placement of municipal orders. Item 7 of the legal document shows that control over placement and execution of municipal orders is carried out by municipalities – but it does not reveal how and on what municipal structure this control shall be exercised.

² “Guidelines to ensure transparency in the budget and tax system. International Monetary Fund, published in Azeri Turkish, p.65

Over the above-mentioned, this investigation will only cover issues of external audit in local government. In Azerbaijan, the external audit is carried out by two bodies:

- 1) Chamber of Accounts of the Azerbaijan Republic;**
- 2) Chamber of Auditors of the Azerbaijan Republic.**

The Accounts Chamber is the state-run legal entity, while the Chamber of Auditors, being a financial institution, is an independent audit body.

In addition, Azerbaijan's Finance Ministry has the right to control over the use of State Budget subventions to local governments. Therefore, it is essential to clarify principles and duties of financial audit in local governments provided by the finance ministry.

1.1. Local government audit carried out by the Chamber of Accounts

State Audit bodies auditing the financial affairs of local governments in separate countries across the world function under different names. They are, for example, called the Supreme Auditing Department in some countries, while the Central Accounts Chamber in the other. In Azerbaijan, this body implementing State Audit is called Accounts Chamber like in French-speaking countries. The existing legislative framework extends to adequate scrutiny of local governments' financial management by the Accounts Chamber. However, the types of the audit service in relation to executive councils and municipal bodies are different.

a) Local executive council audit carried out by the Chamber of Accounts

Under Article 2 of the Law of the Republic of Azerbaijan on "The Chamber of Accounts", state audit of local executive powers covers the following:

- ***accurate spending of State Budget subventions;***
- ***effective spending of off-budget revenues by local governments;***
- ***targeted spending of budgetary allocations;***
- ***accurate drawing up of credit provided to local governments;***
- ***management of the State Property, the supervision over the issue of orders on it and transfer of means from privatization to the State Budget.***

As it can be seen, State Audit of local executive powers/councils not only extends to State Budget funds and subventions, but also to more extensive financial activities. It is worth noting that State Budget funds allocated to local executive authorities in Azerbaijan are divided into two groups: the first group includes means formed on the basis of state tax (payments) collected directly in the catchment areas (of district/city executive authorities); the second group includes State Budget allocations to local executive authorities on a normative basis in order to realize concrete activities and targeted State programs.

Let's consider a concrete example on the practices of audit in local executive authorities the Chamber of Accounts has carried out of late. In 2005 the Chamber of Accounts audited execution of funds allocated to Housing and Communal Services at Baku's Executive Power on expenditure under the functional section "Housing and Communal

Services” of the State Budget.³ The audit revealed that AZN 4.97 mln was to be allocated to the Department in 2005, yet Cash Receipt execution was AZN 4.93 mln. It also revealed that as the Department was not able to collect fees for communal utilities and other services, it had losses of AZN 4.02 mln. And during the second half of 2004 the Chamber of Accounts audited execution of funds allocated to the Main Capital Construction and Repair Department at Baku’s Executive Power on expenditure under the functional section “Industrial and Construction expenditures” of the State Budget.⁴ But neither the Accounts Chamber places related information on its website, nor its reports available to the public contain the results of the monitoring. It is only reported that audit was carried out.

b) Local government audit carried out by the Chamber of Accounts. The Law on “The Chamber of Accounts” also provides for scrutiny of local governments’ financial management. Since under Article 16 of the said law titled “The Authority of the Chamber of Accounts to Perform Financial - Budgetary Expertise”, “the Chamber of Accounts has the authority to perform the financial - budgetary expertise, prepare conclusion and give relevant proposals on the basis of inquiries of the Justice Ministry. The Chamber of Accounts, in case of necessity, can perform audit of enterprises and organizations in the course of analysis of the income and expenditures of the State budget and extra-budgetary State funds (institutions).” However, the cases of necessity for local government audit have not been reflected in appropriate legislative acts.

The Chamber of Accounts not only can audit State Budget funds, but also local budget on the whole. Since according to Article 6 of the Law on “The administrative control over the activity of municipalities”, use of the State Budget funds, owning the municipal property, charging and using it, application of lumpsum local taxes and dues, expenses for municipalities and issues causing financial liabilities are the subject of administrative control over municipalities. So, should the Justice Ministry face a problem in a municipal body during the control process, it may invite the Chamber of Accounts to audit the said issues. For example, the Chamber of Accounts audited Baku’s Hatai District Municipality last year in accordance with Letter # 09/2-63 dated 29 March 2006 from the Justice Ministry’s Center for Work with Municipalities. The audit process aimed to verify accuracy of spending State Budget grants and subventions, as well as means allotted from private sources over the past four years including the year 2006. The audit revealed a number of legal wrongs. For example, it found out that although AZN 17,000 had to be spent on purchase of vehicle means from the 2005 budget approved, AZN 44,100 of budgetary means had been spent during the year without changes to the budget; or when selling land plots to citizens, in most cases the price of land was shown in the sale agreements below the statutory tariff. So it was revealed that as a result of reduced prices, AZN 32,100 had not been allocated to Hatai Municipality budget during the audit period. In addition, the audit also revealed that no lease agreements had been concluded in some cases when municipal land was leased to trade and service facilities, but payments effected unofficially.⁵

³ The Report on the activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, *Baky – 2007*, p. 47

⁴ The website of the Accounts Chamber at www.ach.gov.az has been quoted.

⁵ The Report on the activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, *Baky – 2007*, pp. 62-64

The Chamber of Accounts fails to seek answer to how far the State Budget means under disposal of local executive authorities and local budget funds that constitute the financial base of municipalities are effective. Such audit should have one duty only: was actual budget execution similar to approved budget estimates? If no deviation is discovered as a result of inspection, the auditor issues a positive opinion.

c) Accountability of the Accounts Chamber for audit in local government. Milli Mejlis (Parliament) creates the Chamber of Accounts based on the Article 92 of the Constitution of the Republic of Azerbaijan. According to Article 1 (The status of the Chamber of Accounts of the Republic of Azerbaijan) of the Law of the Republic of Azerbaijan on the Chamber of Accounts, "The Chamber of Accounts is a full-time State budget and finance supervising body, which reports to the Parliament." Article 2 (Main Functions of the Chamber of Accounts) of the said law says that the Chamber of Accounts shall promote Milli Mejlis (Parliament) to supervise approval and execution of revenue and expenditures items of the State Budget.

Under Article 92 (Coordination of Work of Milli Mejlis of the Azerbaijan Republic) of the Constitution of the Azerbaijan Republic that came into force since 27 of November 1995, "the Milli Mejlis of the Azerbaijan Republic shall set up the procedure of Its work, it also shall choose the Chairperson and its Assistants, organize permanent and other commissions, sets up Counting Chamber." Besides, according to Article 8 (The Chairman of the Chamber of Accounts) of the Law of the Republic of Azerbaijan on the Chamber of Accounts, "The Chairman of the Chamber of Accounts shall report twice a year (spring session - not later than 15 of April and autumn session - not later than 15 of October) to Parliament on performance of the Chamber of Accounts. So, the Chamber of Accounts as to Parliament, but not to executive councils.

The existing legislative framework does not provide for accountability of the supreme audit body before media and civil society institutions in a compulsory manner. Article 21 of the Law of the Republic of Azerbaijan on the Chamber of Accounts is called "Promulgation of Information on the Activities of the Chamber of Accounts". It says: **"The Chamber of Accounts regularly informs the mass media on its activities. The reports on the activities of the Chamber of Accounts are submitted to Parliament and published in "The Information of Parliament"**.

For reference, the directory of Milli Mejlis is put out to distribute to members of Parliament and superior State bodies only, and the public have no access to it. The normative documents of the Chamber of Accounts that regulate its activity not only leave out the accountability of this Supreme Audit Body before civil society (including media), but also this body fails to place reports on the results of the audit and expertise actions involving state administration structures as well as municipalities at its official website (www.ach.gov.az). If we visit the website, we can find its recent reports covering the years 2002-2003. To put it more precisely, the latest information placed is about the execution of State Budget 2003 covering the year's first quarter. The document **"The report on the activity of the Chamber of Accounts"** issued on a yearly basis is distributed to members of Parliament and NGO usually access the documents through unofficial contacts.

1.2. Conditions for local government audit delivered by the Chamber of Auditors of the Azerbaijan Republic

In addition, to the Chamber of Accounts that is the State Audit body, there is external Audit - the Chamber of Auditors of the Azerbaijan Republic, carrying out independent check of accuracy of financial accounts, statements and reports in entities dealing with production and sale of goods, delivery of services and deals.

The Chamber of Auditors is an independent financial structure responsible for regulation and development of audit services at government level, supporting proprietary rights of property owners and the interests of government, businesses and auditors (audit companies), ensuring that the rules and procedures stipulated by legislative acts are observed by independent auditors and audit companies. Under Article 3 (Audit Services) of the Law on Auditor Services of the Azerbaijan Republic dated of 16 September 1994, "Audit services include performance (based on mutual agreement) of check, expertise and analysis of financial and business performance of entities with further issuance of reports, statements and confirmation of accuracy of company's financial reports and provision of other services within the responsibilities of auditor." Such audit should, for example, assess financial accountability of local government, the compliance of the accounting system with the existing legislation, instead of auditing how efficiently the local governments use public money.

Under the legislation in effect, both an independent auditor and an audit company can be employed for external audit in Azerbaijan. Independent auditor is a physical person granted rights to deliver audit services on the territory of the Azerbaijan Republic by license provided by the Chamber of Auditors of the Azerbaijan Republic. Audit company is a legal entity granted rights to deliver auditor services on the territory of the Azerbaijan Republic by license provided by the Chamber of Auditors and for which delivery of audit services is determined according to its Charter as the only activity type in which it can be involved. Independent auditors and audit companies can provide services or run business within 5 years after receipt of license upon registration by corresponding state office in the republic.

Issuance of licenses for audit services is subject to Resolution #009 on issuance of special permit (license) for involvement in audit activities in the Azerbaijan Republic dated of 13 January 1998 of the Cabinet of Ministers of the Azerbaijan Republic.⁶

Independent auditors shall be registered in a corresponding state office in order to start private business without forming legal entity. Auditor shall have right to start delivery of audit services from the moment he/she is awarded with audit license. Under Article 6 (Who can be an Independent Auditor ?) of the Law on Auditor Services of the Azerbaijan Republic, the terms of becoming an independent auditor are: a) Citizenship in the Azerbaijan Republic; b) Not to be bounded with obligations (connected with fraud or other criminal infringements) banning occupation of financial positions or involvement in similar activities; c) Education in Accounting, Finance, Economy and Law and minimum 3 years professional work experience in respective areas; d) Stand exams for independent auditor license.

The organizations of license examinations to become an auditor is implemented in accordance with the provisions of the Charter of the Republic of Azerbaijan's Chamber of Auditors approved by Milli Mejlis of the republic on 19 September 1995. Under

⁶ The text of the Resolution has been taken from www.e-qanun.az

Articles 15-18 of the Charter, the license examinations are held by Examination Commission (hereinafter referred to as Commission) formed by the Chamber. The Commission is formed of three representatives from the Chamber, by one representative from the Ministry of Finance of the Azerbaijan Republic, the State Tax office, the National Bank of Azerbaijan, a professor of economy, a representative of independent auditors and a representative of audit companies. The content of the Commission are announced at the beginning of the year by the Chairman. Additionally, members of the Commission should have good experience in audit, and no less than 10 years experience in one of the related disciplines such as accounting, financial control, economy and law.

Under Article 2 (Audit concept) of the Law on Auditor Services, audit can be mandatory and volunteer (by entity's initiative). Audit is mandatory if it is conducted in entities that should publish their financial reports pursuant to country legislation, or in cases stipulated by country laws or by instruction of authorized state office, and is volunteer in all other cases⁷. Consider the Law on Banks of the Republic of Azerbaijan dated of 16.01.2004. Under Article 45 (Publication of balance sheet and external auditor's opinion) of the said law, each bank and domestic branch offices of foreign banks shall, not later than five months after the end of each of its financial years, submit to its shareholders and make available for the public upon request, its audited consolidated financial statements, together with the report of the external auditor, for that financial year (sub-item 45.1) and each bank shall, not later than five months after the end of each of its financial years, submit to the National Bank its audited consolidated financial statements, together with the report of the external auditor, for that financial year. Each foreign bank with one or more domestic representative offices shall submit to the National Bank its audited financial statements accompanied by external auditor's report no later than five months after the end of financial year and its consolidated financial reports accompanied by external auditor's report no later than eight months after the end of financial year (sub-item 45.2). And Under Sub-article 45.3. of the Law, the financial statements referred to in Article 45.1 hereof, shall be published by the bank and domestic branch office of foreign bank in the press in such form and detail and at such time as prescribed by the National Bank⁸.

As to local government audit services delivered by independent auditors, the requirements of the law in relation to executive councils and municipal companies are different.

a) Local executive council audit carried out by the Chamber of Auditors. All the effective legislative acts of the Republic of Azerbaijan – and notably the Provision/Resolution on Local Executive Authority, adopted 16 June 1999, fail to take into account external audit of executive bodies, in addition to State Audit.

The financial affairs of local executive authorities are audited by the two structures only - the Finance Ministry and the Chamber of Accounts. But several State bodies, such as the Presidential Administration, the Office of Public Prosecutor, the Ministry of Interior (MOI), and other state run public authorities may employ the Chamber of Auditors in case there is a need for the financial expertise while monitoring the activity of local executive bodies.

⁷ The text of the Law has been taken from www.e-qanun.az

⁸ The Law on Banks of the Republic of Azerbaijan was published on the issue #73 of official newspaper Azerbaijan on 30 March 2004.

b) Municipalities' audit carried out by the Chamber of Auditors. In accordance with the effective legislation of the Azerbaijan Republic, municipalities are included in the category of economic entities that have to make financial reports to the public and authorized state offices. Surely publication of the accounting (financial) reports of the local governments is far from concreteness and accuracy. For example, under subparagraph 37.7 (Article 37. Execution of the local budget) of the Law of Azerbaijan Republic on Budget system dated 2 July 2002, annual report on execution of local budgets shall be approved in a manner determined by regulations of municipalities, and the population living in the municipal area shall be informed about this. At the same time, Under Article 14.2 of the Law of the Azerbaijan Republic on Accounting, the number of inventories within a reporting year, date of implementation, list of property and liabilities to be inspected during inventory shall be determined by municipal enterprise. The point at issue is that regulations of municipalities have been elaborated based on the Law of the Azerbaijan Republic on approval of model regulations of municipalities dated of October 15, 1999, and the document is in a standard format.

The model regulations consisting of 12 articles do not reflect any information about the financial accountability of municipalities at all. Under Article 12.3 of the Law of the Azerbaijan Republic dated of 27 December, 2001 on "Local (Municipal) Taxes and Payments", the municipalities shall supervise formation and use of budget receipts through ensuring the transparency in this area, as well publish bulletins, place the reports on special boards in front of the municipal office buildings.

Although the publication of the financial reports is not accurate, the municipalities shall be audited once a year (in accordance with the preparation and submission of the annual report on budget execution) subject to the existing law. Since under *Article 39.1 (Supervision over the local budget)* of the Law of Azerbaijan Republic on Budget system, as well as Article 12.2 of the Law on "Local (Municipal) Taxes and Payments", municipality shall supervise the local budget execution, including the correspondence of the spent resources with the approved budget indicators and with this purpose has a right to involve the independent auditors.

In addition to this, there are other provisions in the effective legislations ensuring coercive actions for monitoring of municipalities by independent auditors. Since under item 8.6 of the Law on Municipal Finance, part of budget expenditures not financed by local budget resources - (local budget deficits) can be covered through allotting State Budget subsidies and subventions.

Besides, under article 32.2.2 of the Law of Azerbaijan Republic on Budget system, financial support of the state to local budgets is done through allocating subsidies and subventions from the state budget, when it is impossible to finance local social-economic development programs with local budget funds.

Under subparagraph 11.14 of the said law, the municipalities that require the financial support from the state budget not later that May 1 of the current year shall submit the auditor's opinion to the Finance Ministry. Members of the Auditors Chamber render auditing services instead of appropriate payment.

The cost of the services has been fixed under Resolution #159/5 of the Board of Audit Chamber of the Azerbaijan Republic on Approval of the Minimum Cost of the Audit

Service dated of 23 December 2005⁹. According to the Resolution, the minimum cost of annual audit services shall be differentiated as following, depending on the amount of annual municipal budget:

- a)** The cost of audit services shall be fixed in the amount of US\$ 100 in case the annual budget amount reaches US\$ 500;
- b)** The cost of audit services shall be fixed in the amount of US\$ 300 in case the annual budget amount ranges from US\$ 5,0001 to US\$ 10,000,;
- c)** The cost of audit services shall be fixed in the amount of US\$ 500 in case the annual budget amount ranges from US\$ 10,0001 to US\$ 20,000;
- d)** The cost of audit services shall be fixed in the amount of US\$ 1,000 in case the annual budget amount exceeds US\$ 20,000.

The Audit Chamber has the right to review and change the cost of audit services on a regular basis.

c) Municipal enterprises' audit and their accountability.

According to Article 34 of the Law of the Azerbaijan Republic on the Status of Municipalities dated of July 2, 34,¹⁰ local governments in Azerbaijan have the right to form legal entity. There are no limitations for state registration of municipal entities and companies: they can start delivery of services, having been registered in a corresponding state office in compliance with general procedures applied to other enterprises and organizations regardless of property, organizational and legal forms. And the legislation does not stipulate any limitation or restrictions on the profile of the municipal enterprises/companies, they can be engaged in all kinds of activities unrestricted by Azerbaijan legislation. Under Article 35 of the said Law, the activity of municipal companies is based on the following principles and conditions:

- 1. Municipal companies are independent legal entities, their relations with municipalities are provided through labor and civil legislation;**
- 2. The objectives and conditions of municipal companies and enterprises are defined by municipalities;**
- 3) Prices (tariffs) of their goods (services) are adjusted by municipalities, and the chiefs are appointed and released by municipalities.**

Regarding municipal company accountability, according to Article 35 of "The Law on the Status of the Municipalities", municipal companies, first of all, shall report to municipalities. The reports must cover both the company's production (service) activity and financial results. In addition, the accountability of the said economic subjects has been precisely collated and governed by the Resolution of the Cabinet of Ministers "On approval of registration rules for indicators of municipal enterprises and companies' financial and economic activity" dated of 12 January 2000.¹¹ Under paragraphs 3-4 of

⁹ The text of the Resolution has been taken from www.vescc.com

¹⁰ The text of the Law has been taken from www.e-qanun.az

¹¹ See: the text of the Resolution at www.vescc.com

the Resolution, municipal enterprises shall submit quarterly and annual reports on local budget execution to the State Statistics Committee of the Azerbaijan Republic, while quarterly and annual financial reports to local structures of the Finances Ministry. The financial reports reflect prognosis for local budget receipts and expenditures as well as the present state of affairs on them.

Municipal company audit is voluntary. The audit can be conducted by the initiative of the municipal company or municipality.

1.3. Financial scrutiny of local governments by the Ministry of Finance (MoF)

Although the Ministry of Finance (MoF) is not an audit entity in terms of its functional goal and status, it is entitled by local legislation to perform control over local governments' financial management. The Central Department of State Financial Inspection under the Ministry of Finance (MoF) is running to that end and the activity of local governments is just inspected/audited through this body. There are two main documents the legislative framework of which comprises the legal basis of such scrutiny:

- 1) "Policy on Activities of the Financial Ministry" approved by Decree No. 271 of the Azerbaijan President dated of 4 February 2000;*
- 2) Regulations "On rules for implementation of state financial control by the Finance Ministry" registered by the Justice Ministry of the Azerbaijan Republic dated of July 2,200.*

Much noteworthy is that the MoF has the right, without exceptions, to perform control over local executive authorities' financial management, while its control over municipalities is limited. Since according to art. 1.1.14 of the Law of Azerbaijan Republic on Budget system, donation - gratis financial resources provided from the state budget to the local budgets is allocated in order to balance their revenues and expenditures. That is to say, municipalities are fully independent in preparation, approval and execution of local budgets. Therefore, subsidies cannot be subject to inspection by the Ministry of Finance. However, according to art. 1.1.16. and 1.1.17. of the above-said law, subventions and subsidies are provided from the state budget to the local budgets for financing special purpose events, which are to be retrieved if not spent for these purposes or within determined period of time.

Also, according to art. 39 (Supervision over the local budget) of the said law, in order to ensure the fulfillment of powers that have been given to municipalities by the legislative and executive bodies, the supervision over spending of the allocated resources shall be done by these bodies. Only subvention and subsidies have been provided from the state budget to the local budgets over the past eight years since the establishment of local governments. No targeted funds have been allocated to the local budgets so far. Therefore, the remarks below on the inspection of the local governments' financial activity performed by the Ministry of Finance extend to the local executive authorities only.

So, paragraphs 2 and 3 of the Policy on the activity of the Finance Ministry define duties and functions of the ministry. One of the chief duties of the ministry is to ensure control over budget funding spending, pursuant to paragraph 2.6 of the Policy, while paragraph 3 lists functions vested to the ministry. Under paragraph 3.8 of the document, the ministry performs control over budget funds allocation and their spending in accordance with the budget agreed with the financial bodies, effective use of

approved budget allocations spent to finance investment and innovation programs; develops recommendations to authorized state bodies in case of revealing misuse of state budget funds during local government inspection; governs organizational-methodological provision of the activity of the said bodies; and promotes to bring to bring domestic accounting into line with European accounting standards. According to art 14 and items 6 and 7 of the Regulations, the Finance Ministry shall perform financial control over executive councils in villages and settlements at least once a year, whereas in cities and territorial executive branches through its regional (city) branches (currently, it has 77 branches) at least once every two years.

The inspection scope is as following:

- 1) *Under Article 16 of the Policy, accuracy of approved budget funds spending shall be audited with a view to pay the cost of construction, repair operations financed through budget funds of local governments. The inspection is carried out by an Inspection Team organized by the Central Department of State Financial Inspection and the Team is comprised of qualified specialists majoring in the repair-construction sector. The inspection focuses on full accuracy of accounting operations, final figures, application of single normative rates in the acts as per form # 2 on spending of funds allocated to capital construction and repair activities, and 40% of actual volume of the construction and repair works by a selection method.*
- 2) *Special attention is given to the inspection of performed construction and repair works through tender bidding. In this situation, the Inspection Team audits the lawful calculation of estimated value of the work to be implemented by the tender announcer, compliance of actual work performed by the tender announcer with that shown in the calculations stipulating the estimated value, delivery of work execution and compliance with rules and conditions on payment of the cost as defined by the tender announcer, and finally any agreement attained between the tender announcer and winner whether the cost of work in the contract is +/-10%. In case it is revealed that the difference between contractual and actual work is at a rate exceeding 1000 times of the minimum salary rate¹², all the facilities of the entity is impacted by the inspection;*

At present, it is impossible to access information on the audit outcomes from any official source – and notably the official website of the Financial Ministry¹³ and such reports are made unavailable to the public.

II. The state of development of entities delivering local government audit services in Azerbaijan and staff resources

In all countries, both internal and external audit quality depends on the formation of professional entities delivering audit services and qualified and competent staff resources. Auditing is rather a complicated area: the auditors, in addition to financial issues, must be much versed in economic issues as a whole, including legislation in particular. Most probably, professional requirements made persons willing to deal audit services in many countries stem from the difficulties of the services. In the point of view, can we positively assess the activity of audit institution in Azerbaijan? Let's answer some questions enabling to reveal the real condition of both external and internal audit

¹² Presently, the minimum salary in Azerbaijan is US\$ 58 (AZN 50 at the current rate of the National Bank).

¹³ Website of the Finance Ministry: www.maliyye.gov.az

through instancing in local governments. A key question is what legal requirements have been established in terms of audit organization and activities.

As evidenced by the foregoing, local governments in Azerbaijan are lacking in an internal audit system. The best example for the internal institution is the banking sector. Since the document “**Standards on Internal Audit (SIAs)**” approved by Protocol #24 of the National Bank of Azerbaijan dated of December 29, 2004 envisages the formation of internal audit structures in all banks regardless of the type of property. According to the document, the internal audit department in the banks oversees the bank’s activity to ensure compliance with the effective legislation as well as normative acts issued by the National Bank of Azerbaijan, the bank’s risk adjustment and management, high quality procedures in preparing and applying bank operations, adequacy and precision of accounting information.

But today Azerbaijan lacks appropriate tools required for forming of internal audit of local governments. The point is about the system encompassing the education of internal auditors in the Regulations about internal control over local governments, adoption of professional norms and standards and development of administrative procedures required for internal auditors. Therefore, when speaking about audit requirements, the focus once again will be external audit.

The requirements concerning the member of the Chamber of Accounts are stipulated by Article 7 (Additional Arrangements with Regards to the Members of the Cfhs of Accounts) of the Law of the Republic of Azerbaijan on the Chamber of Accounts that defines the status, functions, organizational structure and forms and principles of activities of the Chamber of Accounts of the Republic of Azerbaijan. It says that, “persons that have high education and 5 years experience of work in the field of public administration, state control, economy and finance are eligible for the positions of the Chairman, Deputy Chairman and Auditors of the Chamber of Accounts. The Chairman, Deputy Chairman and Auditors of the Chamber of Accounts can not be involved in any kind activities that envisage any payment for the performed work unless this is pedagogic, scientific or creative activity. Auditors are elected for the term of seven (7) years by MPs by an overwhelming majority. ” Although the legislation stipulates that the Chamber of Accounts is an independent body and reports to Milli Mejlis (Parliament), the real situation is completely different. Since, the Milli Mejlis it reports to also depends on executive bodies.

Elections to the legislative body are formal. In fact, MPs are elected by supreme executive authorities. This is testified by remarks in the reports of the body: under Article 16 (The Authority of the Chamber of Accounts to Perform Financial - Budgetary Expertise) of the Law of the Republic of Azerbaijan on the Chamber of Accounts, to audit the use of State Budget subsidies in Baku’s several municipalities, the Chamber of Accounts included it in its Work Plan 2006 based on appeal made by the Standing Commission for Regional Issues in Parliament, and in connection with the execution of the task stipulated by the State Anti-corruption Program, as well as given possible arrears revealed in Baku’s Hatai Municipality in the activity that may recur in the activity of other municipalities.

Chief municipal officers (except for Nesimi Municipality) had impeded the audit group that aimed to implement control measures. As a result, the decision the Chamber of Accounts adopted in its meeting on 01.09.2006 had not been executed. According to Section 1, Article 1 of the Law on “The administrative control over the activity of municipalities”, administrative control over municipalities is an activity targeting to ensure compliance with the Constitution and laws of the Azerbaijan Republic, decrees enacted by Azerbaijan President and resolutions issued by the Cabinet of Ministers of

the Azerbaijan Republic by municipalities, municipal bodies and responsible municipal officers; to prevent law breaches in municipalities.

Referring to the said clause of the law, Letter 2/4-04-397 dated of 12.09.2006 was delivered to the Ministry of Justice Center for Work with Municipalities to seek assistance for control measures. Yet no conditions have been created to address implementation¹⁴. If the structure centralized to the Justice Ministry fails to promote the supreme audit body for scrutiny of municipalities, it not worth citing additional facts to prove how weak is this structure in its position in relation with executive bodies.

Besides, if it is impossible to access on the website of the Accounts Chamber its annual State budget execution reports for the past four years, the results of audits delivered in state-run entities as well as local governments, this fact gives cause for some opinion about its independence.

The professional requirement made to the Chamber of Auditors is a key provision. Clause V (Organization of License Examinations) Charter of the Chamber of Auditors of the Azerbaijan Republic defines the requirements as the following:

- 1) The license examinations are held by Examination Commission formed by the Chamber.
 - 2) The Commission is formed of three representatives from the Chamber, by one representative from the Ministry of Finance of the Azerbaijan Republic, the State Tax office, the National Bank of Azerbaijan, a professor of economy, a representative of independent auditors and a representative of audit companies. The content of the Commission are announced at the beginning of the year by the Chairman.
17. Members of the Commission should have good experience in audit, and no less than 10 years experience in one of the related disciplines such as accounting, financial control, economy and law.
18. Members of the Commission are paid salaries, as appropriate.

In addition, under Article 6 of the Law of the Azerbaijan Republic on Auditing Services (Requirements demanded from the independent auditors), an independent auditor in the Azerbaijan Republic is required to have higher education in the field of accounting, finance, economic and legal disciplines, and at least three years of working experience in one's specialty. Independence of the Chamber of Auditors is stipulated by the legislation. But there are points that cast doubt on the independence of this body. For example, under the law, municipalities are free to employ auditors. Unfortunately, conversations with municipalities show that in some cases executive councils have auditors employed for them against the will of the latter. Analysis show that the very auditor or the audit body he represents have personal relations with the executive officers, thus implying that independent check of accuracy of financial accounts, statements and reports in entities is of formal nature, but it mainly targets to earn money by formalizing such services. Lack of statements on the results of audit of municipalities on the official website¹⁵ of the Chamber of Auditors manifests that their activity is of formal character. In general, the reports of the Chamber are fully unavailable to the public, no external subjects have access to them.

¹⁴ Report on the activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, *Baky* – 2007, p. 67

¹⁵ See: the official website of the Auditors Chamber at www.audit.gov.az

Another important matter is to improve knowledge and skills of the entities dealing with external audit, to represent professional associations with a view to applying new standards, as well as to arrange trainings for the auditors in order to improve standards.

According to the Chamber of Auditors, it had developed main 35 and auxiliary 3 audit standards as well as 9 programs on field auditing between the years 1996 and 2005 in order to ensure professional activity¹⁶ (but the wording of the documents has not been placed on the website, or the documents have no print version. Only the members of the Chamber can have access to them on an individual basis). The Chamber also reports that its representatives regularly attend various international events on exchange of experience and perspectives of mutual cooperation organized by international and regional audit and accounting structures, as well as takes measures to become full members of the institutions in order to learn and apply international audit standards. Currently, the Chamber is a cofounder and Board member of "Eurasia" International Regional Federation of Accountants and Auditors, a real member of the European Federation of Accountants and Auditors (EFAA) and a full -associative member of the International Federation of Accountants (IFAC).

But it is impossible to access official information on the issues of training of its specialists. At the same time unofficial contacts with members of the Chamber revealed that they were never through such trainings.

In this situation, the activity of the Accounts Chamber seems to be more professional. Indeed, the management points out that it has not completely provided international audit standards so far. Since although there have been discussions on development of National audit standards in line with INTOSAI standards and diverse variants of the standards have been designed, related activities still remain incomplete.

Regarding the international activity of the Chamber of Accounts, it is member of INTOSAI, EUROSAI, ASOSAI, ECOSAI and of some other international organization of the supreme financial control to seek cooperation in realization of parallel control actions, for an exchange of the appropriate directory materials, to professional training, improvement of professional skills of the staff, etc. That would be suffice to remind that over the past two years alone, its representatives have attended symposiums and conferences on the themes, such as "The role of audit in enhancing accountability in the state sector", "The role and significance of external audit in enhancing government accountability and liability before the public", "Mutual relations with law enforcement and similar agencies", etc.

At the Chamber of Accounts, special attention is given to exchange of foreign experiences in the field of supreme financial control. For example, with funding from INTOSAI, EUROSAI, ASOSAI, ECOSAI, about 20 representatives of the Accounts Chamber and at its own expense, 10 representatives, with a view to improving knowledge and professionalism, have been through the following international courses and trainings: "Audit of privatization", "Audit of sales", "Audit of the environment". "Financial audit", "Audit of incomes".¹⁷

¹⁶ See: the official website of the Auditors Chamber at www.audit.gov.az

¹⁷ Report on the activity of the Chamber of Accounts of the Republic of Azerbaijan in 2006, Baki – 2007, pp. 68-69

References

Fisman, Raymond and Roberta Gatti. 2000. Decentralization and Corruption: Evidence Across Countries? *World Bank Policy Research Working Paper* no. 2290.

Freedom House. 2007. *Nations in Transit 2006: Democratization from Central Europe to Eurasia*. Washington, DC: Freedom House.

Hasanov, Hafiz. 2005. *Municipal Governance: Initial Experience, Problems and Perspectives*. Baku, Azerbaijan: Law and Development Public Union

Huther, Jeff and Anwar Shah. 1998. Applying a Simple Measure of Good Governance to the Debate on Fiscal Decentralization. *World Bank Policy Research Working Papers*, no. 1894.

Law of the Azerbaijan Republic "On Access to Information." 2005.

Global Integrity. 2007. Global Integrity 2006 Country Report: Azerbaijan. (<http://www.globalintegrity.org/reports/2006/pdfs/azerbaijan.pdf>.)

OSCE. 2004. *Press Release: Low polling and some problems accompany Azerbaijan's municipal election. December 21, 2004*. Baku, Azerbaijan: OSCE Baku office.

Weitz Center for Development Studies. 2005. *Needs Assessment of Municipal Services Development: Azerbaijan*.

Wynne Russell, et al. 2005. *Azerbaijan Civil Society Sector Assessment*. Final Report. Washington, DC: Management Systems International. Produced for USAID/Azerbaijan and the USAID Center for Democracy and Governance.

Note; The paper is developed with funding of LGI